Quick Take For The Curious: A Bull Market in the Basics, Part II

Buffett, Bubbles, Bonds & Value Investing

In our Quick Take from April 14, we demonstrated the value of staying calm when the markets are embracing madness. In that note, we highlighted that in a letter to shareholders written in 1980, Warren Buffett advised his partners to avoid bonds (which were yielding 12% at the time) and to buy equities and specifically cited **2020!** In a simple chart we showed that his advice then was absolutely priceless. In that same piece, we warned readers "*For those irritated by our insistent beating of the Buffett & Munger drum you can be sure that we intend to apologize at a quarter-past-never.*"

Today's Quick Take will give our readers a brief look at what Buffett is saying – and doing - today. The below quote is from Buffett's 2020 letter to Berkshire shareholders. If the man won the equities vs. bond debate in 1980 when bond's had double digit yields, our team believes one would be wise to listen today.

And bonds are not the place to be these days. Can you believe that the income recently available from a 10-Year U.S. Treasury bond – the yield was 0.93% at year end – had fallen 94% from the 15.8% yield available in 1981? Fixed-income investors worldwide – whether pension funds, insurance companies or retirees – face a bleak future.
-Warren Buffett, Letter to Shareholders 2020

There are legions of investors and allocators that would suggest Berkshire's current portfolio are powerful expressions of Buffett's belief that bonds are lots of risk and not much return. We would like to amplify a recent "footnote" in the Berkshire holdings. Specifically, the small ($6bn) investment in a collection of Japanese trading companies.

For those unfamiliar with these firms, the always-wonderful-to-read Nikkei Asia penned a terrific piece explaining them found here. If you can't get that link to work, our firm will happily offer any paid up subscriber to our Enterprise Package a complimentary subscription to the FT, Nikkei Asia or The Economist**.** Raised with Churchill's books everywhere, your author knows just how right Churchill was when he quipped "The farther back you look the further ahead you can see."

Nikkei Asia published another article titled "Has Warren Buffett lost his way?" which suggested that Buffett's purchase of these trading companies could be a sign that his investing methods may no longer work. Superbly written by Stephen Givens, we encourage our readers to give his piece a read.[1] **We say this if only because we firmly believe that Buffett himself likely read the article!**

Written in September of 2020, Mr. Givens sagely references Buffett's historic critique of conglomerate discounts. Almost as if no queue, in Berkshire's 2020 letter to shareholders Buffett discusses not just how he thinks about conglomerates but how he distinguishes between "bad" conglomerates and ones that succeed in creating shareholder value. Reading the Nikkei Asia article and then pages four and five of Berkshire's 2020 annual letter it certainly seems like an incredibly amicable conversation occurred!

Summarily, Buffett's explanation of why the Berkshire conglomerate "works" rests largely on the idea that they do not pay absurd and often ego-driven control premiums. This view is very consistent with the manner in which the Japanese trading houses operate. **The critical take-away however is that Buffett funded his purchase of these Japanese trading firms by issuing 30 year Yen denominated debt at below 1%.**

[1] Kailash will happily offer any paid up subscriber to our Enterprise Package a complimentary subscription to the FT, Nikkei Asia or The Economist

Boiled down further: Buffett bought long-term stakes in a collection of firms that benefit from inflation that, prior to any inflation, were already trading at double-digit earnings and FCF yields, paying dividends and buying back stock…and he did so with borrowed and near "free money" selling bonds. In doing so the cost of capital on his positions is nearly zero and he has eliminated the currency risk. This then might be the new frontier of value investing. The ability to take a very long-horizon view, borrow free money for 30 years and buy very cheap equities with substantial free cash flow yields is an incredible form of arbitrage.

Our team of researchers has every expectation this investment method of paying 1% to buy firms with double digit cash yields will turn out very well for Berkshire. We would also note that Buffett has indicated his 5% stakes may rise to nearly 10%. This seems like a classic way for Buffett to get to know the management and understand their commitment to the well-being of shareholders. Makes sense to us that he is signaling an amicable, "not trying to tell you how to run your businesses" approach. Entirely consistent with everything Buffett has historically done and which has worked so very well, he appears to be merely looking to confirm that the managerial acumen he sees in these long-tenured and profitable firms will not be corrupted before investing more Berkshire money.

This is a remarkable way to get short bonds, short fiat money, short a very low and fixed rate of return and long equities, growth, cash flows and compound returns. That the companies frequently traffic in commodities and consumer staples is all the more evidence that this is a bet humanity will continue to buy the basics and that these goods have significant pricing power. **Buffett's "sell bonds to buy cheap beneficiaries of selling basics" is entirely consistent with our theme that investors will be well suited to avoid the manic and overpriced tech space and buy reasonably priced quality.**

Kailash has published a barrage of papers that seek to help long-term investors committed to compounding capital safely find high quality firms at reasonable price. For our work on the opportunity in high quality: midcaps click here, small-caps click here, and for consumer staples in large cap click here and here.

No matter if you are a bear or bullish the history books are unambiguous: buying high quality cash-generating businesses at fair to low prices is a terrific way to compound wealth. Today's market is a highly bifurcated one. Part of the market is trading at obscene multiples as government subsidized capital, weak covenants from lenders and a speculative mania drive some stocks to absurd prices. **The good news is that in these manic times there are pockets of opportunity that we believe, held over the long haul, will provide far better returns than those available in fixed income.**

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For those of you unfamiliar with Kailash, we believe our organization provides cutting edge, thought-driven, investment analysis tools at prices others simply cannot match. Our research staff has been together for over a decade, has well over 100 years of experience. The team includes proven veterans in the investment management business and one of the most prominent academics in the field of behavioral finance. Our services bring the best of breed quantamental tools and themes to your doorstep.

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